Effective Date: July 24, 1995

COORDINATED ISSUE
SHIPPING AND AIR TRANSPORTATION INDUSTRIES
FEDERAL INCOME TAX WITHHOLDING ON COMPENSATION PAID TO NONRESIDENT ALIEN CREW BY A FOREIGN TRANSPORTATION ENTITY

ISSUE:

Whether compensation paid by a foreign transportation entity to nonresident alien crew for services performed within the U.S. on trips between U.S. and foreign destinations should be subject to withholding tax under section 3402 or section 1441?

SUMMARY:

In cases involving international transportation other than transportation to a U.S. possession, the regulations under section 1441 are technically applicable. However, case law also supports withholding under section 3402 in lieu thereof. While employers may follow either approach, in order to avoid unnecessary refund claim procedures and minimize taxpayer burden, the Examination Division recommends that all employers paying wages in conjunction with such international transportation should uniformly withhold tax under section 3402 rather than section 1441.

FACTS:

The issue involves foreign corporations that are engaged in a trade or business in the United States through the operation of ships or aircraft. The ships or aircraft typically sail or fly around the world, transporting cargo and/or passengers. This paper considers the transportation that occurs between U.S. and foreign destinations.[1]

Typically, these foreign corporations employ nonresident alien individuals as crew on their vessels or aircraft. Many of these crew employees do not have a U.S. social security number.

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[1]This paper is confined to transportation between U.S. and foreign destinations (described in section 863(c)(2)(A)), and does not consider transportation that begins and ends in the U.S. on so-called cruises to nowhere (described in section 863(c)(1)) or transportation to or from a U.S. possession (described in section 863(c)(2)(B)).

LAW:

Applicability of Section 3402:

Under section 3402(a)(1), every employer making payment of wages is required to withhold federal income taxes as provided in the regulations. Under section 3401(d), an employer generally means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person. The question under section 3402 is whether the compensation paid to employees who are nonresident alien crew for their services performed while within the U.S. is wages.

Section 3401(a) generally defines wages as remuneration for services performed by an employee for his employer with certain exceptions. Under section 3401(a)(6), an exception from wages is provided for remuneration paid for such services performed by a nonresident alien individual as may be designated by regulations. Treas. Reg. § 31.3401(a)(6)-1(a) provides that all remuneration paid for services performed by a nonresident alien individual is subject to withholding under section 3402, if such remuneration otherwise constitutes wages and if such remuneration is effectively connected with the conduct of a trade or business within the U.S., unless excepted from wages under that section. Treas. Reg. § 31.3401(a)(6)-1(b) specifically provides that remuneration paid to a nonresident alien individual for services performed outside the U.S. is excepted from wages and hence is not subject to withholding under section 3402. For these purposes, performance of services within U.S. territorial waters is considered within the U.S., and performance of services in international waters is considered outside the U.S.[2] The crew's performance of services within the U.S. will necessarily constitute engaging in a U.S. trade or business, and the compensation will be U.S. source income effectively connected to that U.S. trade or business.[3] Thus, but for the application of section 3402(e) discussed below, compensation paid by a foreign transportation entity to nonresident alien crew for services performed within the U.S. or U.S. territorial waters is wages subject to withholding under section 3402.

Section 3402(e) provides, in pertinent part, that if the remuneration paid by an employer to an employee for services performed during more than one-half of any payroll period does not constitute wages, then none of the remuneration paid by such employer to such employee for such period shall be deemed wages. As noted, Treas. Reg. § 31.3401(a)(6)-1(b) specifically provides that remuneration paid to a nonresident alien individual for services performed outside the U.S. is excepted from wages and hence is not subject to

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[2] See Treas. Reg. § 1.861-4(c); Rev. Rul. 75-483, 1975-2 C.B. 286. See also Treas. Reg. § 1.863-4(c).

[3] See I.R.C. §§ 864(b) and (c)(2); Treas. Reg. §§ 1.861-4(a)(1), 1.864-2(a), and 1.864-4(c)(6)(ii)(compensation for performing personal services in the U.S., which constitutes engaging in a U.S. trade or business, constitutes income which is effectively connected with a U.S. trade or business).

withholding under section 3402. Typically, the greater portion of the pay period compensation of nonresident alien crew employed on trips between U.S. and foreign destinations will be attributable to the performance of services outside the United States. Technically, in such circumstances, none of the compensation paid the nonresident alien crew is wages subject to section 3402 withholding under the section 3402(e) all-or-nothing rule.

However, we believe that withholding under section 3402 may apply in these circumstances, notwithstanding section 3402(e). Such conclusion would be drawn by analogy to the conclusion under FICA reached in Inter-City Truck Lines, Ltd. v. United States, 408 F.2d 686 (Ct. Cl. 1969) and Rev. Rul. 79-318, 1979-2 C.B. 352. The Court of Claims construed a similar all-or-nothing rule in section 3121(c) determining the existence of "employment" (since under section 3121(a) FICA wages must be "for employment"). Section 3121(c) provides, in pertinent part, that if the services performed during more than one-half of any payroll period do not constitute employment, then none of the services for such period shall be deemed employment. Under section 3121(b), services performed outside the U.S. do not constitute employment, unless performed by a U.S. citizen or resident for an American employer (or in connection with an American vessel or aircraft and meet other conditions). The employees in Inter-City Truck Lines were Canadian truck drivers employed by a Canadian carrier and who were stipulated in every pay period to perform less than one-half of their services in the United States. Although the Court acknowledged that a literal interpretation might lead to the conclusion that none of the Canadian truck drivers' services were taxable employment, it nevertheless concluded that FICA did apply on so much of their remuneration as was for services performed within the U.S., irrespective of what percentage of the employees' total service in this country and Canada was performed in the United States.

Section 3402(e) applies to payrolls of not more than 31 consecutive days. If the payroll period is more than 31 consecutive days the all-or-nothing rule would not apply and section 3402 withholding is required with respect to that portion of the remuneration which constitutes wages. Treas. Reg. section 31.3402(e)-1(e); see also Rev. Proc. 79-38, 1979-2 C.B. 501 (concerning "end-of-voyage" payroll procedures).

Applicability of Section 1441:

If section 3402 withholding does not apply to U.S. source compensation paid to nonresident crew, then section 1441 withholding applies.

Section 1441 provides, in pertinent part, that any person paying "wages, ... compensations, remunerations, ... or other fixed or determinable annual or periodical gains, profits, and income" constituting U.S. source gross income must deduct or withhold 30% thereof. As already noted, the nonresident crew's performance of services within the U.S. will necessarily constitute engaging in a U.S. trade or business. Therefore, any part of their compensation that is U.S. source will be taxed as income effectively connected to

that U.S. trade or business.[4] While section 1441(c)(1) provides an exception from withholding under section 1441 for certain income that is effectively connected with a U.S. trade or business, this exception does not apply to compensation for personal services performed by an individual.[5] Under section 1441(c)(4), regulations may exempt compensation for personal services from withholding under section 1441. However, the relevant regulations do not provide any exemption applicable in this case.

In pertinent part the regulations pursuant to section 1441(c)(4) provide for only two exemptions, neither of which is applicable. Under Treas. Reg. § 1.1441-4(b)(1)(i), withholding under section 1441 is not required if the personal services compensation of the nonresident individual is subject to withholding under section 3402. However, as discussed above, withholding under section 3402 technically may not apply to the compensation of nonresident alien crew by virtue of section 3402(e). Under section 1.1441-4T(b)(1)(ii), withholding under section 1441 is not required if the personal services compensation of the nonresident alien individual would be subject to withholding under section 3402 but for the provisions of section 3401(a), other than section 3401(a)(6). However, as discussed above, any inapplicability of section 3402 withholding to the compensation of nonresident alien crew is not the result of one of the exceptions under section 3401(a), but rather is the result of the operation of the section 3402(e) all-or-nothing rule.

Accordingly, if section 3402 does not apply, the U.S. source compensation of nonresident alien crew is subject to withholding under section 1441. However, employers that choose to rely on the section 3402(e) argument and so withhold tax under section 1441, rather than section 3402, for wages paid to nonresident alien crew employees in connection with international transportation (other than to U.S. possessions) should be permitted to do so only provided the employer files forms 1042 and 1042S with respect to such payments. No refunds shall be granted unless the refund claim on form 1040NR bears a taxpayer identification number that matches the number stated on the corresponding Form 1042S.

Exceptions to Applicability of Section 1441:

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[4] See I.R.C. §§ 864(b) and (c)(2); Treas. Reg. §§ 1.861-4(a)(1), 1.864-2(a), and 1.864-4(c)(6)(ii)(compensation for performing personal services in the U.S., which constitutes engaging in a U.S. trade or business, constitutes income which is effectively connected with a U.S. trade or business).

Note that the exception for $3,000 or less earned during 90 days or less in the U.S. will not apply, since the foreign transportation entity will itself necessarily be engaged in a U.S. trade or business by virtue of performing services in the U.S. or U.S. territorial waters during trips between U.S. and foreign destinations. See I.R.C. §§ 861(a)(3)(C)(i), 864(b)(1)(A); Treas. Reg. §§ 1.861-4(a)(1)(iii)(a), 1.864-2(b)(1)(i).

[5] Accord, Treas. Reg. § 1.1441-4(a)(1).

Withholding is not required under section 1441 either for compensation for services performed by a nonresident alien individual who is a resident of Canada or Mexico and who enters and leaves the U.S. at frequent intervals, or for compensation which is, or will be, exempt from income tax by reason of a tax treaty to which the U.S. is a party.[6] The regulations set forth the Form 8233 procedure for obtaining the treaty exemption.[7]

Source of Personal Services Income:

Section 1441 only applies to items of income from U.S. sources. Section 863(c) generally sources income from transportation activities. However, wages paid in connection with international transportation between U.S. and foreign destinations are not sourced under section 863(c). Rather, they are sourced under sections 861(a)(3) and 862(a)(3). Under these rules, compensation for services performed in the U.S. is treated as U.S. source, and compensation for services performed outside the U.S. is treated as foreign source.

Since the compensation paid nonresident alien crew for services during trips between U.S. and foreign destinations is partly for services within the U.S. and partly for services outside the U.S., an allocation and apportionment must be made to determine the amount paid for services within the U.S. to which withholding tax under section 1441 applies. As noted, services within U.S. territorial waters are considered within the U.S. for these purposes.[8] The regulations provide for the division to be made on the basis that most correctly reflects the proper source of income under the facts and circumstances of the particular case.[9] In many cases the facts and circumstances will be such that an apportionment on the time basis will be acceptable, that is, the amount to be included in gross income will be that amount which bears the same relation to the total compensation as the number of days of performance of the labor or services within the U.S. bears to the total number of days of performance of labor or services for which the payment is made.[10] In some cases in which

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[6]Treas. Reg. § 1.1441-4(b)(1)(iii)&(iv). The latter provision also would exempt from withholding under section 1441 compensation exempt from income tax under a provision of the Internal Revenue Code. Note, the exemption under section 872(b) for income from the international operation of ships and aircraft would not be available, since crew members are not the operators.

[7]Treas. Reg. § 1.1441-4(b)(2).

[8]See Treas. Reg. § 1.861-4(c); Rev. Rul. 75-483, 1975-2 C.B. 286. See also Treas. Reg. § 1.863-4(c).

[9]Treas. Reg. § 1.861-4(b)(1)(i).

[10]Id. See also Treas. Reg. § 1.863-4(c)("For example, ship wages ... shall ordinarily be prorated for each voyage on the basis of the proportion which the number of days the ship was within the territorial limits of the United States bears to the total number of

taxpayer's services are performed and an accurate record of all of the hours of service is available, an allocation of compensation for labor or personal services performed by the taxpayer between U.S. and foreign sources shall be made by comparing the hours of service performed in the U.S. and the total hours of service.[11]

Inapplicability of FICA and FUTA:

Nonresident alien crew serving on a foreign-flag vessel or aircraft are not subject to FICA or FUTA to the extent that part of their employment is rendered while the vessel or aircraft is outside the United States.[12]

Rules for Resident Aliens Not Addressed:

This discussion is limited to nonresident alien crew members. Different rules apply for U.S. resident aliens or U.S. citizens. Section 7701(b) and the regulations thereunder define when resident alien status is acquired. Generally, there are two tests, one based on permanent immigrant status (green card test) and the other based on presence in the U.S. for a sufficient period of time measured by an objective formula (substantial presence test). In reviewing a time allocation of a purported nonresident alien's service between U.S. and foreign sources, the possibility should be kept in mind that time in the U.S. above a threshold could affect classification of the crew member as nonresident or resident alien.

CONCLUSION:

In cases involving international transportation other than transportation to a U.S. possession, the regulations under section 1441 are technically applicable. However, case law also supports withholding under section 3402 in lieu thereof. While employers may follow either approach, in order to avoid unnecessary refund claim procedures and minimize taxpayer burden, the Examination Division recommends that all employers paying wages in connection with such international transportation should uniformly withhold tax under section 3402 rather than section 1441.

U.S. source compensation paid by a foreign corporation to nonresident alien crew for services performed in connection with international transportation is generally subject to

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days on the voyage ....").

[11]Rev. Rul. 77-167, 1977-1 C.B. 239 (allocation of airline pilot's compensation by comparing hours of flight and required preflight services performed in the U.S. to the total hours of such services).

[12]I.R.C. §§ 3121(b)(4), 3306(c)(4).

withholding tax under section 3402, in accordance with the Department of Treasury, Internal Revenue Service "Circular E" Employer's Tax Guide.

However, employers that choose to rely on the section 3402(e) argument and so withhold tax under section 1441, rather than section 3402, for wages paid to nonresident alien crew employees in connection with international transportation (other than to U.S. possessions) should be permitted to do so only provided the employer files Forms 1042 and 1042S with respect to such payments. No refunds shall be granted unless the refund claim on Form 1040NR bears a taxpayer identification number that matches the number stated on the corresponding Form 1042S.